Petitioners,

CHEMICAL INDUSTRIES P.L.C.,

Respondent.

CHEMICAL

California 94111

Industries PLC

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COUNTER STATEMENT OF QUESTION PRESENTED

Whether a foreign corporation that is denied access to State courts should have standing in federal court to present claims of independent injury arising from a direct conflict of State tax policy with federal foreign commerce policy.

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No. 88-1400

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA; LEONARD WILSON, Individually and as District Manager, Chicago Office of the Franchise Tax Board of the State of California; and B. M. RARANG, Individually and as Auditor, Chicago Office of the Franchise Tax Board of the State of California,

Petitioners,

v

IMPERIAL CHEMICAL INDUSTRIES PLC,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT IMPERIAL CHEMICAL INDUSTRIES PLC

INTRODUCTION

This case is before the federal courts because the State of California imposes a unique tax regime that inflicts economic burdens on foreign nationals in contradiction of federal economic foreign policy. California, through its Franchise Tax Board, *assesses* foreign source income of foreign persons by defining "taxpayer" to include a multinational group of corporations, wherever domiciled or operating, without regard to national sources of income. California *collects* the

tax thereby assessed from that member of the group found in California. This regime impugns the integrity of United States tax treaties with foreign nations and has engendered international protests. The foreign "taxpayer" upon which the economic burden falls is denied access to California courts. Because denial of access to federal courts by foreign parents of multinational groups injured by California's tax regime is, effectively, denial of access to any court, Imperial should have standing. That is all the Seventh Circuit Court of Appeals decided in this case and that decision should be sustained by this Court.

COUNTER STATEMENT OF THE CASE

Proceedings Below. Respondent Imperial Chemical Industries PLC[1] ("Imperial") filed an action in the United States District Court for the Northern District of Illinois against the Petitioners, the Franchise Tax Board of the State of California and the manager and auditor of their Chicago office ("Board"), seeking declaratory and injunctive relief in respect of California income tax assessments. Joint Appendix ("JA") 2, 16. A complaint seeking similar relief based on different facts had been filed previously in the same court by Alcan Aluminium Ltd ("Alcan"). JA 1, 6. The Board filed separate motions to dismiss each complaint on the ground that neither plaintiff had standing to maintain its action in federal court. JA 1, 2, 13, 23.

The district court ruled that Alcan's allegations, if proven, would confer standing and ordered the Board to answer. JA 1, 26. The Board thereafter withdrew the motion to dismiss Imperial. JA 2, 30. The district court then entered a "finding of relatedness" of Imperial's case to Alcan's and assigned both cases to the same judge. JA 2. The Board filed a separate answer to each complaint. JA 1, 2, 31, 34. Both cases were then reassigned to a different judge. JA 1, 2.

[1] The names of corporations affiliated with Imperial that are not wholly-owned subsidiaries are listed in Appendix 1 to Imperial's Brief in Opposition ("Br. Opp."). The worldwide group of companies owned or controlled by Imperial, including wholly-owned subsidiaries, is referred to herein as the "Imperial Group."

On 3 January 1986, Imperial filed a motion for summary judgment together with the summary statement of facts required by district court rule 12(e) in civil actions. JA 3, 103, 105. The Board filed a cross motion for summary judgment on grounds the district court lacked jurisdiction to entertain Imperial's action. JA 3, 135. The Board did not request findings of fact. A similar motion was filed in the related (Alcan) case. JA 3, 133.

On 30 July 1987, the district court granted the Board's motion to reconsider the prior order respecting standing and dismissed each case for lack of standing. JA 4; Appendix to Petition ("PA") A-25—A-27. The district court's opinion makes no findings of fact and makes no reference to the record.

Imperial and Alcan filed separate appeals to the United States Court of Appeals for the Seventh Circuit. JA 2, 4. The court of appeals found that both appellants had "alleged injuries resulting from California's franchise tax that are sufficiently direct and independent of the injuries to their subsidiaries to confer standing." Each case was remanded to the district court for further proceedings.[2]

Imperial's Facts. The worldwide combined income apportionment formula or "unitary method" used by the Board determines the amount of a taxpayer's income attributable to and taxable by California. Under this method, all business activities of commonly controlled corporations that the Board deem to function as a "unitary" business are combined. The combined income is apportioned by a three-factor formula that compares activities conducted in California to activities of the "unitary" business everywhere. JA 46, 47.

For income years 1971 through 1981, ICI Americas Inc. ("Americas"), a wholly owned, U.S. subsidiary of Imperial, filed California franchise (income) tax returns. Americas reported net income apportioned to California by the three-factor formula, using California property, California payroll, and California sales of Americas as numerators and all prop-

[2] *Alcan Aluminium Ltd v Franchise Tax Board*, 860 F.2d 688 (7th Cir. 1988); PA A-1.

erty, all payroll, and all sales of Americas as denominators. JA 43.

For income years 1971 through 1981, the Board audited the California franchise tax returns of Americas. JA 46. Board auditors demanded information relating to consolidating entries of Imperial; intercompany transactions of the Imperial Group; data on worldwide rentals; worldwide property detail; worldwide construction in progress; worldwide payroll detail; and worldwide sales of the Imperial Group. JA 53, 115; Ex. 8, 9, 11, 12.[3] The auditors also sought information on worldwide research facilities and expenditures of Imperial and its subsidiaries. Ex. 8. The auditors requested "a breakdown of the California inventory and property at original cost in historical English pounds." JA 111; Ex. 12. Americas personnel supplied all information within their possession but requested the Board to contact the London office of Imperial for worldwide information that was not in the possession of Americas. JA 111; Ex. 10. Much of the information requested is outside the scope of Imperial's accounting records. JA 54; Ex. 9.

The Board determined that Americas was part of a single, worldwide, unitary enterprise conducted by all members of the Imperial Group. Based upon this determination, the Board recomputed income subject to California tax using as the apportionment base the assumed worldwide income of the Imperial Group. JA 46.

For most of the audit years, substantial increases in Americas' California tax liability resulted from the Board's determinations that Americas was part of a "unitary" business conducted by the Imperial Group and that use of worldwide combined income apportionment was required to determine properly California taxable income. JA 51.

In computing the Imperial Group's income apportionable to California, the Board began with consolidated income of the Imperial Group shown in the financial statements in Imperial's published annual reports, expressed in pounds

[3] "Ex." refers to exhibits accompanying the district court record.

sterling. Adjustments based on information contained in the published annual reports were made by the Board purporting to eliminate exchange rate gains and losses and earnings of corporations owned fifty percent or less by Imperial. Adjustments were also made by the Board to earnings of Imperial purporting to conform the statements to California tax accounting principles. JA 51.

The California apportionment factor was calculated by averaging the three-factor fractions expressed in pounds. To obtain these fractions, numerators expressed in U.S. dollars were supplied to the Board by Americas. These amounts were converted by the Board to U.K. sterling (pounds), using average exchange rates for the year published by the International Monetary Fund. JA 51-52. Denominators of the three fractions expressed in pounds were derived by the Board from Imperial's annual reports. JA 52.

The apportionment factor determined above was then multiplied by the worldwide business income of the Imperial Group shown in the annual reports of Imperial. The result, in pounds, was deemed business income apportioned to California, and was translated into dollars at the International Monetary Fund average exchange rates for the year. The California tax was calculated by applying the current statutory rate to such apportioned income. JA 52.

It is anticipated that assessments for years after 1981 are likely to be proposed by the Board on the same worldwide, combined, Imperial Group income basis as in earlier years. JA 53, 54.

There are significant differences in accounting principles and reporting practices among the United Kingdom and the various nations, including the United States, in which the Imperial Group conducts business. JA 55; JA 117. A major accounting problem involves conversion of transactions from one foreign currency to another. JA 117; Ex. 15.

Imperial projects that the additional administrative cost of preparing California franchise tax returns using worldwide combined income apportionment for the Imperial Group will

be £ two million initially, plus £ two million annually. The cost of reporting and making accounting adjustments required to conform worldwide information to California accounting includes the cost of maintaining a set of records for the Imperial Group to conform to California tax accounting rules and the cost of translating transactions of foreign subsidiaries first to pounds and then to dollars. JA 58; Ex. 22.

Under United Kingdom law, a resident corporation is entitled to (direct) credit for foreign taxes paid on dividends from subsidiaries in overseas countries, and to (indirect) credit for foreign income taxes paid on earnings out of which dividends are distributed. United States federal income taxes and California franchise taxes may qualify for the United Kingdom indirect credit, subject to two limitations: (a) No credit can be obtained for dividends paid from years in which the dividend paying subsidiary records a net book loss; and (b) no credit is allowable in excess of the amount of United Kingdom tax exigible on the dividends paid. JA 57; Ex. 19.

Americas incurred book losses for income years September 30, 1972 ($6,819,633); September 30, 1973 ($27,434,974), and December 31, 1975 ($2,038,420). JA 45. Americas was assessed California taxes for these years based on apportionment of Imperial's worldwide income, respectively, of $72,956 (1972); $1[illegible]2,966 (1973); and $42,011 (1975). JA 48.

Where taxable income of a U.S. subsidiary corporation of a U.K. company is increased over its book income by worldwide combined income apportionment, the effective California tax rate for U.K. tax credit purposes is increased, since only book income of the U.S. subsidiary may be taken into account when computing the amount of foreign tax subject to U.K. credit. JA 118-119; Ex. 19.

Application of the worldwide combined income apportionment formula to determine California taxes of subsidiaries of foreign corporations that, like Imperial, have no connection with California except through commerce with a subsidiary doing business in California, has resulted in increasingly vigorous objections from the nations that are major trading partners of the United States. JA 55-56; Ex. 17. From 1980 through 1984, the United States Department of State and Department of the Treasury received communications from the governments of the United Kingdom, Canada, Australia, The Netherlands, Belgium, Switzerland, West Germany, Japan, and the member states of the European Community. Ex. 17 (parts 1 through 14). These statements objected to worldwide combined income apportionment, such as used by California, on grounds of double taxation, costs of compliance, interference with foreign commerce, and failure of the United States Government to speak with one voice in foreign affairs. JA 120-121; Ex. 17.

In 1985, the United Kingdom enacted standby legislation authorizing their treasury to withdraw substantial United Kingdom tax credits from United States companies domiciled in or having 7.5% or more of their property, payroll, or sales in a State requiring worldwide combined income reporting. JA 57, 120-121; Ex. 18.

SUMMARY OF ARGUMENT

The decisions of this Court in *Japan Line, Ltd. v County of Los Angeles,*[4] and *Container Corp. v Franchise Tax Board,*[5] establish that a State tax on an instrumentality of commerce owned by a foreign corporation is prohibited by the commerce clause if it interferes with the ability of the United States Government to "speak with one voice" in foreign affairs *or* presents a risk of double taxation. The instant case arises from the manifest conflict between federal foreign economic policy and California's unitary tax policy as administered by the Board. Imperial is within the class of persons intended to be protected by federal foreign economic policy and can demonstrate injury to its own commerce by the Board's actions. California does not provide a forum in which Imperial can make its claim of injury to its own commerce by the Board's actions. The remedy sought and the decision

[4] 441 U.S. 434 (1979)
[5] 463 U.S. 159 (1983)

of the court of appeals, below, do not create a risk of interference with normal State collection procedures. Neither principles of federal abstention, comity, nor the Tax Injunction Act should, therefore, bar Imperial's action in federal court.

ARGUMENT

I. IMPERIAL IS THE PROPER PARTY TO INVOKE PROTECTION OF FEDERAL FOREIGN COMMERCE POLICY THAT CONSTITUTIONALLY OVERRIDES CALIFORNIA'S UNITARY TAX POLICY.

The injuries alleged by Imperial as grounds for standing are precisely the injuries alleged by Imperial as grounds for relief on constitutional principles. The standing issue, therefore, directly implicates the conflict between federal foreign economic policy and California's unitary tax policy. Accordingly, the constitutional limits on the Board's unitary method of taxation and the federal foreign economic policy to which that unitary method must yield are first addressed.

A. The Constitution Prohibits California's Interference With Federal Foreign Commerce Policy.

Constitutional limits on the power of the States to tax enterprises with worldwide business have been addressed in a series of Supreme Court decisions beginning with the case most relevant here, *Japan Line.*[6] That case established the proposition, reaffirmed in *Container Corp.*,[7] that a State tax on instrumentalities of commerce owned by a foreign corporation is prohibited by the Commerce Clause if it limits the ability of the United States Government to speak with one voice in foreign affairs or presents a risk of double taxation.

In *Japan Line,* Los Angeles County asserted a property tax on shipping containers owned by a Japanese company

[6] *See infra* p. 7, n. 4. Other relevant cases are *Mobil Oil Corp. v Commissioner,* 445 U.S. 425 (1980); *Exxon Corp. v Wisconsin Dept. of Rev.,* 447 U.S. 207 (1980); *ASARCO Inc. v Idaho State Tax Comm.,* 458 U.S. 307 (1982); and *F.W. Woolworth Co. v Taxation and Rev. Dept.,* 458 U.S. 354 (1982).

[7] *See infra* p. 7, n. 5.

that were temporarily located in the county on the tax lien date. In ruling that the tax was prohibited by the Commerce Clause, this Court held that burdens on foreign commerce are subject to limitations not applicable to interstate commerce:

> The premise of appellees' argument is that the Commerce Clause analysis is identical, regardless of whether interstate or foreign commerce is involved. This premise, we have concluded, must be rejected. When construing Congress' power to "regulate Commerce with foreign Nations," a more extensive constitutional inquiry is required.
>
> [441 U.S. at 446.]

Japan Line carefully reserved judgment on the taxability of "domestically owned instrumentalities engaged in foreign commerce."[8] That issue came before this Court in *Container Corp,* which involved application of California's worldwide unitary apportionment to a domestic parent corporation with foreign subsidiaries. This Court held the tax not to be prohibited by constitutional limitations, but in so doing, this Court nevertheless affirmed the constitutional standard stated in *Japan Line:*

> If the unitary business consisting of appellant and its subsidiaries were entirely domestic, the fact that different jurisdictions applied different methods of taxation to it would probably make little constitutional difference .... Given that it is international, however, we must subject this case to the additional scrutiny required by the Foreign Commerce Clause. [Citation omitted] The case most relevant to our inquiry is *Japan Line.*
>
> [463 U.S. at 185.]

This Court concluded that *Japan Line* was distinguishable on essentially two grounds. The first was that the property tax in *Japan Line* necessarily resulted in double taxation, whereas double taxation of the income of a multinational business results from combination of different methods

[8] 441 U.S., n. 7 at 444.

of allocation and thus depends solely on the facts of the individual case.[9]

The second distinction was that in *Japan Line* the economic burden of the tax fell on the foreign owner, not on a United States corporation.[10] The opinion emphasized this second ground by expressly reserving decision on factual circumstances of a case such as Imperial's:

> We have no need to address in this opinion the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries.
> [463 U.S., n. 26 at 189]

The issue reserved by this Court in *Container Corp.* is the fundamental issue in the present case: Does federal foreign commerce policy, which is granted supremacy under the Commerce Clause, prohibit the Board's application of the worldwide combined income apportionment formula to a foreign parent corporation and its worldwide subsidiaries?

Under principles established in *Japan Line* and *Container Corp.*, the tax asserted by the Board in the present case is prohibited by the Constitution because it simultaneously involves risk of double taxation and limits the ability of the United States Government to speak with one voice in foreign affairs.[11]

B. THE BOARD'S UNITARY TAX METHOD CONFLICTS DIRECTLY WITH ESTABLISHED FEDERAL FOREIGN COMMERCE POLICY.

1. *The Arm's Length Separate Accounting Method of Taxation is a Federal Foreign Economic Policy.* This case is before this Court because California's worldwide, unitary,

[9] 463 U.S. at 188.

[10] *Ibid.*

[11] JA 57; Ex. 17-1 through 17-14; Ex. 18. See also *amicus curiae* brief, submitted in district court by the United States Department of Justice, pp. 17-23 ("DoJ brief").

combined income assessment method[12] cannot be reconciled with the nearly universal acceptance of the arm's length method. That method treats related corporations as separate, economic entities and requires them to deal with one another on the same basis as they deal with unrelated parties. Taxable income is determined by separate accounting for each of these entities provided they observe the arm's length principles.

Federal foreign policy and, to a large extent, foreign commerce policy are Executive prerogatives. The Executive has firmly embraced and promoted the arm's length method. In recommending legislation to Congress that would prohibit use of worldwide unitary taxation, the Secretary of the Treasury stated unequivocally that the Executive agreed with the contentions of the foreign governments respecting States' use of worldwide unitary taxation and that, "It has become clear that the ability of the federal government to speak with one voice in the conduct of foreign economic affairs is significantly weakened because of these state tax practices."[13] In this very case, Executive support of the arm's length method was clearly stated by the United States.[14]

Congress has affirmed the use of the arm's length separate accounting method in two ways. Congress has ratified tax treaties between the United States and its trading partners which incorporate the arm's length method. The United States—United Kingdom Income Tax Convention of 1975,[15] like all other United States tax treaties, plainly establishes the "arm's length standard" of international taxation—as contrasted with California's unitary tax method—through the following provision:

> The business profits of an enterprise of a Contracting State shall be taxable only in that State unless

[12] California is virtually alone among the fifty States and alone in the world in applying worldwide, unitary, combination. All but four States—Alaska, California, Montana, and North Dakota—have now abandoned worldwide unitary taxation. Montana does not apply the method to foreign parent multinationals. Alaska appears to apply the method only to domestic parents and foreign parent oil companies.

[13] JA 124.

[14] DoJ brief p. 22-23.

[15] 31 U.S.T. 5668, T.I.A.S. 9682.

the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. [Art. 7(1)]

The definition of a "permanent establishment" (Art. 5) does not include a subsidiary corporation unless it operates as a branch of the foreign parent. The foreign parent's foreign source profits, hence, are not taxable in the subsidiary's domicile.[16] This arm's length result is exactly the opposite of California's unitary method.

Congress has enacted federal tax laws that establish federal tax policy with respect to foreign commerce. The arm's length separate accounting method is embodied in Internal Revenue Code[17] ("Code") § 482 and the regulations thereunder as well as in the income sourcing rules of Code §§ 861, 862, and 863. Dividends received from a foreign corporation are treated as foreign source income unless 25% or more of the foreign corporation's income is "effectively connected" with the conduct of a trade or business in the U.S.A. by such foreign corporation. The Code, in addition, grants foreign tax credit to dividends received from foreign corporations, both for foreign withholding taxes on such dividends (§ 901) and for taxes on the underlying income that produced such dividends (§ 902). Since the laws of the United Kingdom and other treaty partners contain similar provisions with respect to foreign dividends paid to their own nationals, it is beyond dispute that the arm's length method is the internationally recognized norm as well as the United States norm. This was the basis for the numerous protests of record[18] by foreign governments as well as the statements by the President and the Secretaries of State and Treasury

[16] The Board argued in the district court that failure of the necessary two-thirds of the United States Senate to accept the United Kingdom Tax Convention's express prohibition against States' use of unitary taxation demonstrates Congressional intent to permit States to use the method internationally. But not enacting a prohibition is altogether different from granting permission. A majority of the Senate actually approved the prohibition and the arm's length standard remains embodied in tax treaties later adopted as well as in the Internal Revenue Code.

[17] Tit. 26 U.S.C.

[18] *See infra* pp. 6-7.

opposing California's international application of the unitary tax method.[19]

2. *Protection of Direct Foreign Investment Through a Domestic Subsidiary is a Federal Foreign Economic Policy.* For many years the federal government has by treaty, statute[20] and administrative action[21] fostered foreign direct investment in the United States and encouraged United States persons similarly to invest abroad. The United States—United Kingdom Income Tax Convention[22] illustrates the treaty protections that are offered reciprocally to foreign investors who choose to establish domestic subsidiary corporations in the United States. Similar provisions are found in U.S. tax treaties with many other trading partners within the Organization for Economic Cooperation and Development (OECD). [23] The more important provisions are:

(a) The subsidiary files U.S. tax returns reporting only its own income. The U.K. parent does not have to file U.S. income tax returns and pays no U.S. taxes on income that is not "effectively connected"[24] with U.S. operations. [Art. 7.]

(b) If 10% or more of the capital stock of the subsidiary is owned by a U.K. parent, double taxation of dividends is eliminated through granting reciprocal tax credits for income taxes paid on the subsidiaries' income from which dividends are paid. [Art. 23.]

(c) Where countervailing income adjustments are made by the respective (U.S.—U.K.) tax authorities that result in double taxation, a "competent authority" procedure is established to determine which nation has

[19] JA 122-124; Ex. 23; Ex. 24.

[20] This foreign economic policy has been firmly established by statute since enactment of the Foreign Investors Tax Act, Tit. I, P.L. 89-809, 89th Cong. 2d Sess. (1966), 80 Stat. 1539.

[21] DoJ brief pp. 18,19, and Exhibit A; JA 122-125.

[22] *See infra* p. 11, n. 15.

[23] Principally, Australia, Canada, Federal Republic of Germany, France, Italy, Japan, The Netherlands, and United Kingdom.

[24] As defined in INT. REV. CODE § 864(c) and the U.S.—U.K. Income Tax Convention.

the primary right to tax the income in question and to relieve the double tax effect. [Art. 25.]

Based on these standard treaty provisions,[25] a foreign corporation may insulate its own income from U.S. (federal) tax if it chooses to operate through a separately incorporated, U.S. subsidiary.[26] Reciprocal protection is granted to a U.S. company operating through a subsidiary in the U.K. Because California's tax regime directly contravenes this protection, an international conflict has arisen.

3. *Taxation Based on Origin of Income is a Federal Foreign Economic Policy.* Both the treaties and the Code create a primacy of origin rule for taxing income. That is, income should be first taxed in the nation in which it was earned and should not be taxed a second time in the nation to which it is paid as a dividend except incrementally where the tax rate in the recipient's domicile exceeds the rate in the payor's domicile.[27] California's unitary method ignores this rule; gives no credit for foreign taxes paid on foreign source income; is unable to provide any equivalent to the "competent authority" procedure; and imposes both tax and compliance burdens on international enterprises that extend far beyond any conceivable nexus with California or, for that matter, the United States.

[25] Similar encouragement and protection is given by provisions granting exemption from withholding taxes to interest on debt (Art. 11) and royalties for the licensing of intellectual property (Art. 12).

[26] INT. REV. CODE § § 861, 862, 884.

[27] E.g., U.S. Model Income Tax Treaty Convention of June 16, 1981, 1 CCH Tax Treaties ¶153; INT. REV. CODE § § 861, 862, 901, 902.

C. IMPERIAL SUFFERS SPECIFIC DIRECT AND INDEPENDENT INJURIES FROM CALIFORNIA'S INTERFERENCE WITH FEDERAL FOREIGN ECONOMIC POLICY.

1. *The Specific and Direct Injuries.* As a foreign investor having chosen to operate through direct investment in a U.S. subsidiary, Imperial is clearly within the class of intended beneficiaries of the federal economic policy and is entitled to the protection of the accord negotiated between the United Kingdom and the United States. The Board acknowledge that the legal principle by which this case must be decided is well established: Imperial has standing if it shows that it suffers some direct injury which is independent of those suffered by Americas.[28] The Board's actions create three specific burdens for Imperial: Economic double taxation; excessive cost of compliance; and unwarranted intrusion into fiscal decision making. These are described following:

(a) *Economic Double Taxation.* Economic double taxation results when the recipient of dividend income cannot obtain a credit in its nation of domicile for foreign taxes paid by the subsidiary that earned the income. In the instant case, the United States and the United Kingdom avoid this result by similar foreign tax credit provisions. Reciprocal credits are provided Under Art. 23 of the U.S.—U.K. Tax Convention.[29] The Board completely misconstrues the nature of the economic double taxation of which complaint is made: "Obviously, if the asserted taxes are measured in part by income earned and taxed elsewhere, it is the corporate taxpayers [Americas] which must bear the burden of the resulting double taxation."[30] This is entirely beside the point. The burden complained of here is borne by Imperial.

Imperial can *never* obtain U.K. tax credit for the California tax assessed and collected for the three loss years of Americas, 1972, 1973, and 1975.[31] The reason, as explained in the affidavit from the Inland Revenue Solicitor,[32] is that

[28] Petitioner's Brief ("Pet. Br.") pp. 22-23.

[29] *See infra*, p. 11, n. 15; p. 13, ¶(b).

[30] Pet. Br. p. 37.

[31] JA 44.

[32] JA 118-120; Exhibit 19.

U.K. credits are only available for foreign taxes paid in years in which income is earned by the subsidiary. Since California imposed taxes on income that Americas didn't earn under the international arm's length standard applied by the United Kingdom, no credit for those California taxes can ever be claimed by Imperial. The income that was taxed belonged to other members of the Imperial Group that had no connection with California. The results of these three years illustrate economic double taxation in its purest form. Americas is taxed by California on *deemed* income and the actual recipient of that income, Imperial, cannot get relief for the California tax against income that the U.K. clearly has the superior right to tax under the 1975 Convention.

Similarly, with respect to years in which Americas had income, the amount of U.K. tax credit that will be available to Imperial for California taxes will be reduced proportionately by the amount of foreign income the unitary formula apportions to California. If the foreign income is large and Americas' California income is small, the incidence of further double taxation necessarily increases. Americas pays California tax on income earned by and taxed to the Imperial Group.[33] While Imperial may claim U.K. credit for the foreign taxes on that same worldwide income, Imperial gets no U.K. credit for the California tax. The California tax, in effect, becomes a discriminatory tax imposed on U.S. source income by reason of including in the tax base foreign source income that is exempt from federal tax.

(b) *Excessive Costs of Compliance.* Compliance with the Board's worldwide combined income reporting requirement by a foreign parent multinational enterprise involves recordkeeping that is quite extraordinary for the normal course of business, a fact that is recognized by the Board's regulations 25137-6(e)(1).[34] The Board's information requests to Americas demand a great deal of foreign data which, if

[33] Since Imperial is deemed a "taxpayer" with capital invested in California and payroll in California, its foreign source income is subjected to California tax assessment even if no sales are made into California. CAL. REV. & TAX. Code § § 25101, 25121, 25128.

[34] Appendix 1, *infra*, reproduces Reg. 25137-6 in full.

available at all, could only come from Imperial.[35] In order to comply fairly with the Board's information requests, differences in accounting principles among foreign nations must be rationalized;[36] foreign currencies must be converted; foreign property values must be restated; and elaborate reports must be created in conformity with the requirements of the Board.

The cost of doing this is overwhelming. The estimated annual cost of £ two million for Imperial to establish and maintain the accounting system required is greater than the total amount of franchise tax that the Board has, so far, assessed over a ten year period on the Imperial Group's foreign source income taxed to Americas.[37]

The Board observed that Imperial is complaining about the expense of the compliance effort and that this expense diminishes the value of Imperial's investment in Americas.[38] The latter point may be true but is not part of Imperial's complaint. What the compliance cost really diminishes is the cash in Imperial's own accounts. To make matters worse, this expense cannot be deducted by anyone for U.S. federal income tax purposes. Imperial is not subject to United States income taxes,[39] and if the expense were reimbursed by Americas to Imperial, the payment by Americas would not be deductible for federal income tax purposes because it relates to income not subject to federal tax.[40] Even if directly incurred by Americas, the expense would be nondeductible for the same reason. Any nondeductible payment by Americas to Imperial to reimburse such costs would be a non-

[35] JA 115-118.

[36] The Price Waterhouse Survey (Ex. 15) identifies several dozen fundamental accounting policies as to which the practices or requirements in sixty-four countries vary widely.

[37] JA 48; JA 117.

[38] Pet. Br. p. 39.

[39] INT. REV. CODE §§ 882(a) & 884(e)(1).

[40] INT. REV. CODE § 265. The Treasury (IRS) long ago determined that legal fees incurred by an alien in contesting a foreign tax are not deductible to the extent allocable to foreign tax on income exempt from (U.S.) federal tax. Rev. Rul. 62-9, 1962-1 CB 35. U.S. Treasury regulations require State unitary tax assessments on foreign source income to be allocated to that income in the same manner as *foreign* taxes on such income. Reg. § 1.861-8T, Example (25).

deductible deemed distribution for federal and State tax purposes subject to the usual rules on distributions, which include federal dividend withholding taxes.

The point is that the irreconcilable conflict of California's practice with that of the federal government and the international community puts foreign investors such as Imperial in an untenable position with respect to compliance. After setting elaborate and detailed requirements for production of extensive data to compute the tax, observance of which would give rise to the large compliance costs estimated in this case, the Board's regulations offer this alternative: "In appropriate cases, such as when the necessary financial data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations."[41] The result is that if accounting data to support the taxpayer's position is not available, or if the cost to produce it is likely to exceed the tax, California tax must be determined by negotiation with the Board. In negotiations, the Board will always have the upper hand because of the burden of proof. This is, apparently, exactly what the Board intended.

There is no way of meeting the burden of proof without incurring the compliance costs. It clearly would be too expensive for Imperial to undertake compliance without any assurance it would reduce its taxes. The Board acknowledge their negotiating advantage in the present case by asserting[42] that "any additional information furnished by the parent companies" would not substantially alter the amount of taxes on the Imperial Group's income.

(c) *Interference with Decision Making.* As parent company of a multinational group comprising hundreds of subsidiaries in more than 50 nations, Imperial has major planning and fiscal responsibilities. While Imperial's investment and strategic decisions affect all members of the Imperial Group, many of those subsidiaries are largely autonomous with regard to their own investment and operating decisions. A

[41] Reg. 25137-6(e)(1). *See infra* Appendix At 1-8.
[42] Pet. Br. p. 39, n. 13.

principal complaint Imperial has about the Board's tax regime is that so long as the California numerators of the three factor apportionment fraction remain constant, any change in the worldwide denominators increases or decreases taxable income apportioned to California. If a subsidiary with property, payroll, and sales in India is sold by Imperial, each of the three apportionment fractions increases and the California tax assessment increases. Similarly, if the managers of an autonomous subsidiary in India decide to sell its plant, the sale will increase California taxes.

The California method of assessment draws no distinction between a parent company and a subsidiary. While the court of appeals did not share Imperial's view of the "upstream" effect (i.e. the Board's treatment of the subsidiary as though it controlled its parent), the economic reality is that subsidiaries in one country do not make or even participate in decisions affecting investment and operations in another country. The court of appeals focused on the opposite effect, i.e., the "downstream" aspect of unitary taxation that treats the subsidiary as a branch of the parent. The point made by the court of appeals was that California's tax regime forces the foreign parent to avoid subsidiary operations in California and operate, instead, through arm's length contracts in order to protect its foreign source income from California tax.

It is this constraint that clearly contravenes federal policy. It is absolutely correct that by choosing to deal through arm's length contracts with independent distributors and commission agents when making sales into California, Imperial can insulate its foreign source income from California tax assessments. The Board not only misstate[43] what the court of appeals said, but totally confuse the issue by arguing[44] any taxable income Imperial receives from California would have to be determined under the unitary method. The point the court of appeals was making is that if Imperial only *sells* into California through arm's length contracts, Imperial doesn't have California source income. By not having Califor-

[43] Pet. Br. p. 27.
[44] Pet. Br. p. 28.

nia source income, Imperial *would not be subjected* to worldwide unitary tax assessment.

Comparison of the court of appeals opinion[45] with the Board's argument[46] reveals the extent to which the Board have tried to obfuscate what the court of appeals intended. The pivotal issue is simply this: Does the Board have the right to force a foreign parent to avoid subsidiary operations in California in order to protect its foreign source income from California assessment? If California were a sovereign nation, the answer would clearly be "yes." But as a member of a federal republic that specifically gives the prerogative of foreign economic policy to the federal government, California has surrendered that right. The federal government's choice in foreign commerce, not California's, should prevail in this case.

2. *Imperial's Injuries are Independent of Those to its Subsidiary, Americas.* Based on the opinion of the court of appeals, the Board assert that Imperial's allegations of double taxation and excessive compliance costs do not constitute injuries that are independent of those to Americas. The Board, furthermore, attack the court of appeals finding that the burden on Imperial's decision-making is sufficiently direct and independent to confer standing. The Board's assertions are in error.

It is irrefutable that actual double taxation exists or will exist in this case because of the "serious divergence in the taxing schemes adopted by California and the foreign taxing authorities."[47] The court of appeals below, suggested that "it is possible to view these taxes . . . simply as added costs for the domestic subsidiary . . . . "[48] This view may be possible but Imperial bears directly the incidence of this tax when the United Kingdom tax credit is denied on dividend distributions from excessively taxed income of Americas. The burden of double taxation is an injury suffered by Imperial directly, not indirectly through Americas.

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[45] 860 F.2d, n. 10 at 697.
[46] Pet. Br. n. 9, at 27-28.
[47] *Container Corp.*, 463 U.S. at 187.
[48] 860 F.2d at 696.

It is irrefutable that the Board's worldwide combined income reporting requirements imposed on Imperial are both extensive and expensive. The court of appeals, however, noted that the cost of compliance like double taxation, "can be viewed, in principle, as an increase in the overhead of the California operations."[49] While this view may also be possible, the burden of complying with the Board's information requests nevertheless falls directly on Imperial, not Americas. Only Imperial has access to Imperial Group information regarding worldwide revenue and cost data, worldwide payroll accounts, worldwide cash movement, and worldwide property accounts.

In addition to the double tax and compliance burdens, the incidence of California's unitary tax impermissibly impairs Imperial's ability to plan and conduct foreign commerce without interference from California. The court of appeals correctly found that the unitary tax burdens Imperial's foreign commerce by discriminating against the use of subsidiaries in commerce which could be conducted without worldwide tax exposure through arm's length arrangements. The Board distort the court of appeals analysis by ignoring the fact that no California taxes are imposed on Imperial's worldwide income as a result of commerce with non-affiliates and that it is the *possibility* of shifting "a higher proportion of the corporate tax burden onto companies that are affiliated with foreign operations"[50] which is the constitutionally significant offense. The Board's attack on the court of appeals finding that Imperial "could conduct precisely the same foreign commerce" through unaffiliated companies as it does through Americas ignores commercial reality. No reason exists why Imperial could not contract with an independent company to conduct research, manufacture to Imperial's specifications, or conduct any other commercial activity in California for that matter without subjecting Imperial's foreign source income to California tax.

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[49] *Ibid.*
[50] 860 F.2d at 697, n.10.

The Board finally argue[51] that this Court has already rejected Imperial's "classic" argument against formula apportionment, most recently in *Shell Oil Company v Iowa Dept. of Rev.*[52] That statement simply ignores the facts in *Shell Oil.* The taxpayer was a Delaware corporation being assessed proportionally on its own "unitary" income within and without the State of Iowa but *entirely within* the jurisdiction of the United States. No one now seriously questions the use of unitary apportionment by the States to tax U.S. source income. *Container Corp.* makes it clear that the foreign source income of a U.S. parent and its subsidiaries also may be so apportioned and taxed. The taxpayer's argument in *Shell* was that Congress had exempted by statute income from the sale of Outer Continental Shelf oil and gas. This Court concluded that there was no intent by Congress to grant such an exemption. This principle has nothing to do with the instant case. The Board's argument in this respect serves to highlight what is the central feature of their tax regime: That unitary apportionment may be applied by them to any multinational group, irrespective of nationality, irrespective of federal economic policy, irrespective of the difficulty it creates for foreign based businesses irrespective of foreign retaliation against U.S. businesses, and wholly irrespective of the impact on foreign relations of the United States.

II. CALIFORNIA DOES NOT PROVIDE A FORUM TO HEAR CLAIMS OF INJURY ARISING FROM INTERACTION OF FEDERAL LAW WITH FOREIGN LAW.

The sole remedy in California State courts is a claim for refund of taxes paid. No declaratory or injunction relief respecting classes of income or persons assessed is permitted. Imperial, itself, as the Board concede is denied access to California courts. What the Board argue is that Imperial's claims of double taxation, compliance costs, and interference with decision making should be litigated on Imperial's behalf

[51] Pet. Br. p. 37.

[52] __U.S.__ 109 S. Ct. 278, 102 L. Ed. 2d 186 (1988).

by its subsidiary, Americas. Since Imperial's claims cannot be litigated in California courts, the Board are actually seeking to have Imperial's claims declared non-justiciable.

A. As The Court of Appeals Held, Imperial Has No Remedy in California Courts.

The court of appeals held that California did not provide an adequate remedy under the circumstances of this case. Imperial urges that the record as well as the admission in the Board's brief [53] that "California affords remedies only to the taxpaying entities," support that holding.

Whether Imperial's claims are substantial enough to sustain a claim of independent injury is something that should be decided by the trial court after weighing all of the evidence. If Imperial is denied standing, the trial court will never consider the evidence of direct injury. All the court of appeals decision gives Imperial is a chance to prove the nature and extent of allegedly independent injuries.

The Board captiously argue that even though Imperial has no standing in a California court it follows that Imperial is not thereby deprived of effective State remedies.[54] Imperial submits, to the contrary, that it *is* deprived of a remedy. Under California law, the exclusive remedy to contest the tax in California court is a taxpayer's action for refund of taxes paid.[55] California law prohibits injunctive relief in a California court to enjoin the assessment or collection of a tax.[56]

The only California worldwide unitary tax case that involves a foreign parent is a refund action that does not address standing.[57] In that case, the plaintiffs were a California corporation and its United Kingdom parent. Both corporations were California taxpayers and both had standing in California to sue for refunds of taxes collected. The California trial court held the worldwide unitary tax to be unconstitu-

[53] Pet. Br. p. 43.

[54] *Ibid.*

[55] Cal. Rev. & Tax. Code § 26102.

[56] Cal. Rev. & Tax. Code § 26101.

[57] *Barclay's Bank Int. Ltd. v Franchise Tax Bd.*, No. 32059, Cal. Super. Ct. (Sacramento Co., 1987), *appeal pending.*

tional on foreign commerce and other grounds similar to those urged by Imperial in the instant case.

B. AMERICAS DOES NOT HAVE STANDING IN A CALIFORNIA COURT TO LITIGATE THE INJURIES ALLEGED BY IMPERIAL.

Americas, unlike Imperial, is not within the class of foreign investors protected by federal foreign commerce policy. None of the three issues alleged as injuries by Imperial can be fully dealt with in a California refund suit by Americas against the federal policy background.

1. *The Economic Double Taxation Issue.* Under the Board's unitary tax method, Americas will pay no foreign taxes but will pay a California tax measured by foreign source income earned by foreign corporations. As shown previously, Americas may claim that its tax is measured by excessive income, but may not claim *double* tax because the double tax arises when a U.K. tax becomes due without a credit. To make a claim of impermissible double taxation, therefore, Americas has to base its claim on Imperial's income and Imperial's foreign taxes, and it must do so in a refund suit that does not include Imperial.

2. *The Excessive Costs of Compliance Issue.* The extraordinary costs of compliance must be borne initially by Imperial, because the required information must be derived from the accounting records of Imperial and its subsidiaries outside the United States. The costs and burdens, consequently, would not in the first instance be costs and burdens imposed on Americas and Americas would again be forced to assert someone else's burden in an Americas' California refund action. Although payment of these costs might as a business matter be shifted to Americas by Imperial, an unconstitutional burden on foreign commerce cannot be so readily shifted.

If such shifting or sharing were treated, moreover, as simply converting Imperial's cost into an intercorporate distribution by a subsidiary to its parent corporation, the result would be, as explained previously, that the cost could never

then be charged against income for tax purposes by any entity in any jurisdiction.

3. *The Interference With Decision Making Issue.* There is no way in which Imperial's decision-making power can be said to be shared with Americas. As a subsidiary corporation, Americas has no voice or participation whatever in the decisions made by Imperial. This is true of Imperial's decision to incorporate or purchase Americas, Imperial's continuing decision in owning Americas and any future decision to dissolve or sell Americas. Even more to the point, the same conclusion applies to Imperial's decision as to its capital investments in foreign countries other than the United States, which as explained above, are decisions directly impacted by California's unitary tax. They are not, however, decisions which Imperial shares with Americas.

If the California courts would recognize corporations as taxpayers on the basis of assessments rather than collections, Imperial itself would have standing in California courts and the Tax Injunction Act or comity would apply to bar standing in federal court. Such is not the case and the court of appeals, below, correctly held that "comity and federalism, weighty as these concerns are where federal courts pass on the constitutionality of State tax legislation, cannot justify withholding federal jurisdiction from a party with no cause of action in State court to redress its own direct and independent injury."[58]

The Board make several arguments to refute this point, none of which withstands analysis. The Board argue that "any constitutional objection that the parent companies have are shared with the taxpayer subsidiaries."[59] This sweeping generalization does not fit the facts of this case.

The Board's position in this case rests on the uncontroverted proposition that a shareholder has no standing to litigate claims based on injury to the corporation (Imperial, of course, is pressing its own claim of injury, not Americas'). Since this is so, it follows with equal or greater force that a

[58] 860 F.2d at 699.

[59] Pet. Br. p. 48.

corporation has no standing to raise claims based on injury to its shareholders. The Board will inevitably take that position in any California refund action by Americas and their present assertion (or even concession) to the contrary in this case would not be binding on a California court in a refund action by a party (Americas) not before this Court.

The Board argue that their conclusion that the constitutional objections of Imperial are shared with Americas follows from *Exxon Corp. v Governor of Md.*,[60] stating that, "... the Clause protects the interstate market, not particular interstate firms, from prohibited or burdensome regulations."[61]

Exxon Corp. did not involve standing at all, nor was the quoted statement directed toward standing. It was instead an affirmation that the Commerce Clause protects commerce as a whole, not some particular market structure and was a refutation of the argument that a State statute violated the Commerce Clause because it would change the market structure by weakening the independent refiners who were plaintiffs. While the quoted statement is true the Board's argument is a non sequitur. The statement does not address whether a foreigner's burdens are shared with a domestic company. The statement addresses the substantive issue of State taxing power, not the standing issue. It is plain that the Commerce Clause cannot be invoked in the abstract; it can only be invoked by a litigant having the individual rights protected by the Commerce Clause, and then only if the litigant has suffered an injury.

Exxon Corp. and the authorities cited therein simply support the uncontroverted proposition that the Commerce Clause implicates national and State interests in an adjudication of the merits of a claim, and do not address the standing of a party to raise the claim.

[60] 437 U.S. 117 (1978).

[61] *Id.* at pp. 127-128.

C. The Decision of the Court of Appeals Does Not Grant Licence to Shareholders to Restrain State Tax Assessments in Federal Court.

A number of States who have stated that they have no interest in the constitutionality of California's worldwide unitary tax, joined in a brief as *amici curiae*, asking that standing be denied in this case. The fear expressed by this brief, and by that of the Council of State Governments, the National League of Cities and others, is legitimate but unfounded. Imperial agrees with the statement in the *amicus* brief that "the appropriate party to litigate the validity of their taxes is the taxpayer and that the appropriate forums are their State courts."[62] Under the Board's interpretation of California law, Imperial *is* the taxpayer for assessment but is *not* the taxpayer for payment or refund suit.[63] The Board, in fact, admit this but apparently do not regard it as inconsistent or burdensome.[64]

Where the States' Brief errs is in the statement that the court of appeals opinion, below, "provides a blueprint for avoiding the will of Congress in this area as expressed in the Tax Injunction Act (28 U.S.C. § 1341)."

The decision of the court of appeals in this case cannot be separated from the facts and the relief sought upon which it is based. This action does not seek to restrain either collection or enforcement of California taxes against Americas. What is sought is a declaration that California, in *assessing* those taxes, may not include Imperial, a nonresident alien with no U.S. source income, as a "taxpayer" together with Americas. The only reason for this lawsuit is that, after having included Imperial as a "taxpayer," Imperial isn't

[62] Brief of the State of Idaho ("States' Brief") as *amicus curiae*, p. 2.

[63] Cal. Rev. & Tax. Code §§ 25129, 25130, 25131, and 25134. This "multifaceted" use of the term by California was noted in *Appeal of Finnigan Corp.*, 88-SBE-022 (1988) by the California State Board of Equalization. See discussion on p. 4-4, Imperial's Brief in Opposition, Appendix 4 (reprint of the opinion in full).

[64] Pet. Br., p. 40, n. 14: "... [T]he term taxpayer in the second clause refers to all components of the unitary business but the same term in the first clause refers only to the entity doing business in California." Cf. FTB Reg. § 25137-6(a)(1), *infra*, Appendix at 1-1.

allowed to protest that assessment in California on the only grounds that matter—the federal Constitution and federal foreign economic policy. It is impossible to conceive of another set of facts or a taxing regime other than the Board's application of California's unitary method that would, in combination, permit an action of this nature in federal court.

There is no dispute as to the principles of law respecting standing to be applied. These were stated in *Simon v Eastern Kentucky Welfare Rights Org.*[65] to be: Whether the injury is likely to be redressed by a favorable decision; whether the plaintiff has a concrete injury as contrasted with an abstract concern; and whether the injury can fairly be traced to the defendant as distinguished from some third party.

The enquiry, thus, is factual and Imperial urges that it has satisfied all three principles upon the present record. The issue of highest concern in the States' Brief is not standing but federal court jurisdiction to interfere in State assessment and collection procedures. The case most relevant to that issue is *Fair Assessment in Real Estate v McNary.*[66] This Court held that the Tax Injunction Act as well as principles of comity barred a taxpayer's damage action in federal court that alleged unconstitutional administration of a State tax system based on unequal assessments on property. But this holding rested on the express finding that "the adequacy of available . . . . [State] remedies is not at issue in this case."[67] The question here is, therefore, does California provide Imperial with an adequate remedy? As demonstrated above, the answer is plainly "no."

If there is truly concern that shareholders generally will use the court of appeals decision as authority to enjoin State assessment and collection proceedings, this Court should rule, explicitly, that such is not the case. The reasons are:

> (a) The object of this action is only to restrain California from including Imperial's income from sources without the United States in California's apportionment base. California is the only State to make such an apportionment. There is no interference with California's audit and collection process vis-a-vis the income of the U.S. subsidiary, Americas, as determined under federal law and international practice. This is not a device to avoid State court, it is the only recourse since Imperial is barred from State court.

[65] 426 U.S. 26, 38-44 (1976)
[66] 454 U.S. 100 (1981).
[67] 454 U.S. at 116.

> (b) The court of appeals decision requires *all three* of the following to be present before a *foreign* parent can have standing to claim injury by State action:
>
> > (i) There must be an area of recognized federal supremacy involved, such as war, issuance of money, foreign relations, or foreign commerce into which the State action intrudes.
> >
> > (ii) The federal government must not have given its permission to the State to make the intrusion, either expressly or by implication. In *Container Corp.*,[68] this Court found that applying worldwide income apportionment to a *domestic* parent didn't have enough impact on U.S. foreign relations and commerce to constitute such an intrusion.
> >
> > (iii) There must not be a method by which the claims of injury to the foreign parent can be adequately presented in the State's courts.

The court of appeals correctly held that unless all three of these elements are present in a tax case, the federal courts should not hear the case. It also correctly held, and Imperial urges this Court to affirm, that all three elements are present in this case and that Imperial therefore has standing. Imperial urges this Court to affirm that holding and to grant Imperial the opportunity to prove its case.

[68] *See infra* p.7, n. 4.

CONCLUSION

For the reasons stated, the decision of the Seventh Circuit Court of Appeals, below, should be affirmed and the case remanded to the District Court for the Northern District of Illinois for further proceedings.

Respectfully submitted,

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APPENDIX

California Franchise Tax Board Regulation Section 25137-6 Combined Reports Including Foreign Country Operations; 18 Cal. Admin. Code § 25137-6

(a) In General.

(1) Unitary Business. A taxpayer is engaged in a unitary business (or a single business within the meaning of Reg. 25120(b) when its activities within the state contribute to or are dependent upon its activities without the state. A unitary business exists when there is unity of ownership, unity of operation and unity of use.

(2) Translation Method for Determining Income. The translation method to be used for determining income shall be the "profit and loss method" as set forth in this regulation. This method excludes unrealized exchange rate gain or loss resulting from the restatement of assets or liabilities, while taking into account exchange gains or losses attributable to income transactions.

(3) General Applicability of UDITPA Regulations. The general regulations for UDITPA, Regs. 25120-25139, inclusive, shall be applicable except as otherwise provided in this regulation.

(b) Determination of Income.

(1) The income of a unitary business with operations in foreign countries shall be computed in the following manner:

(A) A profit and loss statement shall be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

(B) Adjustments shall be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this regulation.

(C) Adjustments shall be made to the profit and loss statement to conform it to the tax accounting standards required under Division 2 Part 11 of the Revenue and Taxation Code.

(D) The profit and loss statement of each branch or corporation, whether U.S. or foreign, shall be translated into the currency in which the parent company maintains its books and records in accordance within subsection (b)(4).

(E) Business and nonbusiness income as determined under California law shall be identified and segregated. For general definition, rules and examples for determining business and nonbusiness income, see Regulation 25120.

(F) Nonbusiness income shall be allocated to a specific state pursuant to the provisions of Sections 25124 to 25127, inclusive of Division 2 Part 11 of the Revenue and Taxation Code.

(G) Business income shall be included in the combined report prepared for the unitary business and shall be apportioned on the basis of the appropriate formula for the business.

(H) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(2) In lieu of the procedures set forth in subsection (b)(1) and subject to the determination of the Franchise Tax Board that it reasonably reflects income, a unitary business with operations in a foreign country may determine its income on the basis of the consolidated profit and loss statement prepared for the related corporations of which the unitary business is a member which is prepared for filing with the Securities and Exchange Commission. If the business is not required to file with the Securities and Exchange Commission, the consolidated profit and loss statement prepared for reporting to shareholders and subject to review by an independent auditor may be used.

(A) Adjustments shall be made, if necessary to:

(i) conform to the accounting principles generally accepted in the United States for the preparation of such statements, except as modified by this regulation;

(ii) conform to the tax accounting standards as required under Division 2 Part 11 of the California Revenue and Taxation Code; and

(iii) eliminate unrealized gain and losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values.

(B) Business and nonbusiness income as determined under California law shall be identified and segregated. For definitions, rules and examples for determining business and nonbusiness income, see generally Regulation 25120.

(C) Nonbusiness income shall be allocated to specific states pursuant to the provisions of Sections 25124 to 25127, inclusive of the Revenue and Taxation Code.

(D) Business income shall be included in the combined report prepared for each unitary business and will be apportioned on the basis of the appropriate formula for each business.

(E) Income from California sources shall be expressed in dollars in accordance with subsection (b)(4) and the taxes computed accordingly.

(3) For purposes of subsections (b)(1)(B), (b)(1)(C), and (b)(2)(A), the following rules shall apply:

(A) Accounting adjustments to be made to conform profit and loss statements to those utilized in the United States—

(i) Include but are not limited to the following:

(I) Clear reflection of income. Any accounting practice designed for purposes other

than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment shall be required where an allocation is made to an arbitrary reserve out of current income.

(II) Physical assets, depreciation, etc. All physical assets, including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset, and no effect shall be given to any such allowances determined on the basis of a factor other than historical cost.

(III) Valuation of assets and liabilities. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under subsection (b)(3)(B). For example, an adjustment shall be required where inventory is written down below market value.

(IV) Income equalization. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law.

(ii) Currency gains or losses on closed transaction are includible, but no adjustments shall be made, or otherwise reflected, for unrealized gains or

losses resulting from the restatement or revaluation of assets or liabilities to reflect changes or fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records and normally conducts its business affairs. In the case of borrowing in a foreign currency, the transaction shall not be deemed closed until repayment is made.

(B) The tax accounting adjustments to be made shall include, but are not limited to, the following:

(i) Accounting methods. The method of accounting shall reflect the provisions of Section 24651 of the Revenue and Taxation Code and the regulations thereunder.

(ii) Inventories. Inventories shall be taken into account in accordance with the provisions of Sections 24701 through 24706 of the Revenue and Taxation Code and the regulations thereunder, except Regulation 24702-24706(b)(5).

(iii) Depreciation, depletion, and amortization. Depreciation, depletion, and amortization are to be computed in accordance with California law.

(iv) Elections.

(I) Elections required to be made for purposes of determining income under Division 2 Part 11 of the Revenue and Taxation Code of all California reporting entities shall be made in accordance with applicable provisions of such law and the regulations adopted pursuant thereto.

(II) Elections required to be made for purposes of determining income under Division 2 Part 11 of the Revenue and Taxation Code for

entities which are not subject to taxation by California but are required to be included in the combined report for the unitary business shall be made by agreement of all entities required to report to California in accordance with the applicable provisions of such law and the regulations adopted pursuant thereto. If agreement cannot be reach, such income shall be reported on the basis of United States generally accepted accounting principles.

(C) No adjustment shall be required under subsections (b)(3)(A) and (b)(3)(B) unless it is material. Whether an adjustment is material depends upon the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or a nonrecurring nature.

(4) For purposes of determining income, necessary translations shall be made at the following exchange rates:

(A) Depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred.

(B) All other items shall be translated at either the end-of-year exchange rate or at the simple average exchange rate for the translation period. Income repatriated during the year shall be translated at the exchange rate at date of repatriation. It is presumed that the translation rate used in preparing the consolidated profit and loss statement for financial reporting purposes is proper absent a showing that some other method is appropriate.

A change from end-of-year rates or average rates may not be made without the permission of and on such conditions as the Franchise Tax Board may prescribe.

(c) Computation of Factors. In computing the formula factors, the following rules shall apply:

(1) Property Factor.

(A) Fixed assets shall be valued at original cost as defined in Reg. 25130(a) and translated at the exchange rate as of the date of acquisition.

(B) Rented property, capitalized at eight times its annual rental rate, shall be translated at the simple average of the beginning and end-of-year exchange rate.

(C) Inventories shall be valued at original cost and shall be translated at the exchange rate as of the date of acquisition.

(D) For purposes of calculating the property factor of financial corporations, financial assets are translated at the year-end rate and are defined as assets reflecting a fixed amount of currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities held, or reasonably expected to be held, for less than six months shall be translated at year-end rates. If a security is held, or reasonably expected to be held, for more than six months, it shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset is determined.

(E) The property factor shall be computed in the currency of the parent company unless the taxpayer requests and the Franchise Tax Board determines that computing the factor in dollars or any other currency fairly reflects the taxpayer's activities in California.

(2) Payroll and Receipts Factors.

(A) Translations shall be made at the simple average of the beginning of end-of-year exchange rates unless there is a substantial fluctuation, as described in subsection (d)(2).

(B) Where the value of the foreign currency does fluctuate substantially, as described in subsection (d)(2)

the exchange rate appropriate to that period shall be either (1) a simple average of the month-end rates, or (2) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

(C) In computing the payroll and receipts factors, translation shall be made into the parent company's currency in order to properly determine the percentage factor to be used unless the taxpayer requests and the Franchise Tax Board determines that computing the factors in dollars or any other currency fairly reflects the taxpayer's activities in California.

(d) Exchange Rates.

(1) For purposes of preparing combined reports, exchange rates may be derived from any source which is demonstrated to the satisfaction of the Franchise Tax Board to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such demonstration, the exchange rates taken into account in computation of the earnings and profits of the foreign corporation shall be determined by reference to the free market rate set forth in the pertinent monthly issues of *International Financial Statistics* or successor publications of the International Monetary Fund.

(2) In general, the extent of fluctuation is substantial if the closing rate for any calendar month ending within the period varies by more than 10 percent from the closing rate for any preceding calendar month ending within the period.

(e) Application of Regulation.

(1) In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records

maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations.

(2) A taxpayer may request an advance determination under subsections (b)(2), (b)(3)(C), (c)(1), (d)(1) or any other provision of this regulation by submitting a determination to the Legal Division of the Franchise Tax Board. Such a determination shall be made on an individual basis and shall be limited to the particular facts or circumstances set forth in the determination request. The facts and circumstances upon which a determination is made remain subject to review. Failure to request or to obtain a favorable advance determination will not be preclude consideration of requested variances in subsequent proceedings.